BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MABERT FINANCE CO., INC.)
dba ALLIED FINANCE'CO.)

Appearances:

For Appellant: Sidney Beress
Certified Public Accountant

For Respondent: Karl F. Munz
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Mabert Finance Co., Inc., dba Allied Finance Co., against proposed assessments of additional franchise tax in the amounts of $1,355.94, $1,401.22, and $2,178.69 for the income years 1976, 1977, and 1978, respectively.

The issue presented for decision is whether respondent abused its discretion in recomputing a reasonable addition to appellant's bad debt reserve.

Appellant is a California corporation which operates as a commercial lender. It is an accrual basis' taxpayer which has selected the reserve method of accounting for its bad debts. For the income years 1976, 1977, and 1978, appellant deducted $8,875, $8,007, and $17,512, respectively, for additions to its reserve for bad debts. Appellant maintained its reserve at 3 percent of the loans outstanding at the end of its tax year.

Respondent determined that the'deductions were excessive and recomputed the additions to the reserve by using the six-year moving average formula derived from the decision in Black Motor Co., 41 B.T.A. 300 (1940), affd. on other grounds, 125 F.2d 977 (6th Cir. 1942). This formula computes an addition to a bad debt reserve by taking into account the taxpayer's actual experience with bad debts for the current and prior years.1/ The formula produced six-year moving average ratios of 1.12 percent, 0.93 percent, and 0.797 percent for income years 1976, 1977, and 1978, respectively. Using these ratios, respondent determined that there should have been no' addition to appellant's reserve for any of these years. Accordingly, respondent disallowed the entire deduction for additions to the bad debt reserve for each year.

Appellant contends that it has used its method of computing additions to the bad debt reserve since its incorporation in 1959 and that the Internal Revenue Service accepted the method *in 1961.* Appellant further contends that this method is used by most small loan companies and cites a 1979 annual report of personal property brokers issued by the California Department of Corporations which shows a 3.86 percent reserve for bad debts for commercial lenders.

Section 24348 of the Revenue and Taxation Code provides, in part:

1/ The details of the calculation are set out in Black Motor Co., supra, 41 B.T.A. at 302.

> There shall be allowed as a deduction debts which become worthless within the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts.

By its election to use the reserve method for deducting bad debts, appellant has chosen to subject itself to the reasonable discretion of respondent. (Union National Bank and Trust Co. of Elgin, 26 T.C. 537, 543 (1956); Appeal of Livingston Bros. Inc., Cal. St. Bd. of Equal., Oct. 16, 1957.) Because of the express statutory discretion given respondent, the burden of proof on appellant in overcoming a determination by respondent is greater than the usual burden facing one who seeks to overcome the presumption of correctness which attaches to an ordinary notice of deficiency. Appellant must do more than demonstrate that its additions to the reserve were reasonable: it must establish that respondent's determination of the additions was so unreasonable and arbitrary as to constitute an abuse of discretion. (Roanoke Vending Exchange, Inc., 40 T.C. 735 (1963); Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.)

As guidance for the determination of a reasonable addition to the bad debt reserve, respondent's regulations provide:

> What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the income year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the income year, including those arising currently as well as those arising in prior income years, and the total amount of the existing reserve.

(Former Cal. Admin. Code, tit. 18, reg. 24348(g)(2) (repealer filed Sept. 3, 1982; Register 82, No. 37).)

Respondent utilized the Black Motor bad debt formula. This formula was approved by the United States Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979), and by this board in

Appeal of Brighton Sand and Gravel Company, decided August 19, 1981. Since it is settled that the Black Motor formula is valid, the only question is whether respondent abused its discretion by using the formula in this case. If a taxpayer's recent bad debt experience is unrepresentative, or the taxpayer can point to conditions that will cause future debt collections to be less likely than in the past, the taxpayer is entitled to an addition larger than the Black Motor formula would provide. (Thor Power Tool Co. v. Commissioner, supra, 439 U.S. at 549.)

In the present case, appellant has used a method to compute the addition to its reserve for bad debts that will keep its reserve at three percent of the loans outstanding at year's end. This method does not take into account appellant's actual experience with bad debts for the current and prior years. Since appellant has not experienced losses of three percent or more of loans outstanding, appellant's contention that its method of computation is used by most small loan companies is not material to the determination of this appeal. In regard to appellant's contention that the Internal Revenue Service accepted appellant's method of computation for the 1961 tax year, appellant has not established that it used the same method of computation of its bad debt reserve at that time or that the same circumstances existed in 1961 as in 1976, 1977, and 1978. Further, a federal audit of appellant's return for 1961 occurred so long before the years at issue that such acceptance is irrelevant.

We conclude that appellant has failed to show conditions that will cause future debt collections to be less likely than in the past. Therefore, appellant has not carried its burden of showing that respondent's application of the Black Motor formula is arbitrary in this case. Accordingly, we find that respondent did not abuse its discretion in recomputing appellant's bad debt reserve.

Appeal of Mabert Finance Co., Inc.,
dba Allied Finance Co.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Mabert Finance Co., Inc., dba Allied Finance co., against proposed assessments of additional franchise tax in the amounts of $1,355.94, $1,401.22, and $2,178.69 for the income years 1976, 1977, and 1978, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of October, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9